# - FINANCIAL LETTER -
## FOURTH QUARTER 2023

**2023 REVIEW**

The resilient US economy is expected to grow by around 2.5% in 2023, according to the World Bank, and unemployment stood at 3.7% at the end of the year. In Canada, growth is estimated at 1.1%, while unemployment rose to 5.8% from 5.0% a year ago. Europe is estimated to have grown by 0.4%, with Germany stagnating at around -0.3%. India is the fastest-growing economy in 2023, at around 7.2%. In its January 2024 report, the World Bank estimates world growth in 2023 at 2.6% and forecasts 2.4% for 2024, the third consecutive year of slowdown.

The year 2023 in the stock market was the year of Artificial Intelligence (AI), the sudden reversal of the U.S. central bank's statement that it plans to cut interest rates three times in 2024, and the unexpected resilience of U.S. consumer purchasing power. These three factors propelled the S&P500 up 23.5% (in CAD and including dividend), mainly due to the seven technology mega-companies, which now make up almost a third of the index. The price-earnings ratio (P/E last 12 months) of the S&P500 rose from 21.6X a year ago to 26.3X on December 31, 2023. The index's price rise has been strongly affected by higher expectations and very little by actual earnings growth, which is currently estimated to have essentially stagnated at 0.8%. The hope that has propelled the stock markets is above all that interest rates will fall rapidly in 2024 and that AI will generate extraordinary profits in a short span. We have our doubts about both these expectations. In our view, the U.S. index most representative of an individual investor's well-diversified portfolio is the equally-weighted S&P500. This is the same 500 stocks as the S&P500, but rebalanced quarterly so that each stock represents 1/500 of the index; this index made 10.8% in 2023 (in CAD) and its P/E is 18.0X. The Canadian stock market gained 11.8% including dividend, and the European stock market (MSCI Europe) 16.7% in CAD including dividend.

The stock market is an emotion machine, exaggerating on both the upside and the downside most of the time; but in the long term, it reflects actual profits. After a sharp rise in 2023, it's worth remembering that North American stock markets have produced a return of around 9% over the last century (about 6.5%-7% net of inflation).

**Artificial Intelligence**

After the Internet revolution of the late 1990s and early 2000s, and the mobility and cloud computing revolution of the 2010s, the most important investment theme of this third decade is the development of generative artificial intelligence. We're still in the early stages of this revolution, and like any revolution, it will take place in fits and starts, with setbacks and advances over many years. Social and legal adaptation will also involve trial and error over a long period. Already, most industries are rapidly

positioning themselves to adapt; be it the software sector, financial companies, industrials, technological equipment and materials, biotechnology and healthcare, transport and logistics, armaments, etc. Our difficult task is to decipher which companies will see their stock prices adequately reflect these changes. It really isn't obvious. At least we can stay away from the greatest excitement and exaggeration. At the other end of the spectrum, some companies are doing quiet but solid R&D work, without fanfare, and their valuation hasn't changed yet. This is where we prefer to cast our fishing line. One example is medical research. The benefits of AI in this field are likely to be huge, and will revolutionize human health. For example, researching a new drug costs an average of US$2.7 billion, the failure rate is very high and the time required for development approaches 10 years. AI is likely to bring a marked reduction in costs, shorter lead times and improved success rates. Current valuations of stocks in this industry (apart from those that have benefited from obesity drugs) still reflect historical returns on invested capital (ROIC), whereas we believe that future ROICs will be higher and should justify a better valuation per unit of profit. But this will probably take several years, and the stock market is not patient. We believe that the precise timing of a paradigm shift is unpredictable, and we prefer to invest in the sector and wait, as the future risk/reward ratio seems favorable to us.

## Our investments

**"Simplicity is the ultimate sophistication".**

**-Leonardo da Vinci**

Investment success is a question of long-term batting average. We'll have good years, and we'll have bad years. We'll score base hits and will slip on banana peels. 2023 was a very good year. Here are the returns for our model equity portfolio:

**As of December 31st, 2023 (annualized for a period exceeding 1 year)**

| | 1y | 3yrs | 5yrs | 10 yrs |
|---|---|---|---|---|
| Préfontaine Portfolio | 31.5% | 19.2% | 16.7% | 14.0% |
| Reference index | 11.4% | 9.8% | 11.8% | 10.4% |
| Difference | 20.1% | 9.4% | 4.9% | 3.6% |

Returns before fees, including dividends. Comparable index (total return - TR i.e. including dividends and in CAD) adjusted each year according to the allocation of the Préfontaine Portfolio; as of December 31st, 2023, 59% S&P500 Equal-Weighted TR, 37% S&P TSX TR and 4% MSCI Europe TR. Over the entire period, the Préfontaine Portfolio is made up of all Stéphane Préfontaine and Fondation Préfontaine-Hushion accounts and serves as a model for the portfolios of Préfontaine Capital clients.

We draw four main lessons from the past (accepting that our hindsight is always perfect at 20/20 and that the usual - and easy - human reflex is to regret not investing enough after a price rise and regret investing too much after a price fall):

1/ Although 14% is excellent, we could have done better over 10 years, as during the first half of this period our portfolio proved to be a little too conservative.
2/ However, we believe that our accumulated experience is reflected in the more recent trend, which is especially good. The 3-year and 5-year periods in particular are hard to beat for a traditional, diversified portfolio of listed equities. Our learning curve over the last few years has steepened and, we believe, should bode well for our future returns.

3/ Our objective is superior risk-adjusted performance. In this respect, our portfolio stands out. Over the past 10 years, no period has been negative except for 2018 at -0.6% and 2022 at -1.0%, which has allowed us to sleep well.
4/ Nothing can be taken for granted in investments, and we must always remain vigilant and adapt to changes. Past returns do not guarantee future returns.

Our best-performing stock in 2023 was Intel (+90%), which recovered from a sharp fall in 2022. Our worst-performing stock was Johnson Johnson (-11.7%, or -8.7% after dividend).

In 2023, we have continued our gradual adjustment of the portfolio towards a greater weighting of mid-sized companies with greater potential over 5 to 10 years. We believe that reindustrialization in North America will be an auspicious theme. We will also see major transformations in healthcare and technology. The housing stock and infrastructures will need to be upgraded. We are constantly and intensively on the lookout for new ideas, where the risk of permanent capital loss is low compared to the upside potential.

***The following sections are reserved to clients of Préfontaine Capital***

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